

The University of Chicago

CANADIAN WAR-TIME FISCAL POLICY
1939-45

A PART OF A DISSERTATION SUBMITTED TO THE FACULTY
OF THE DIVISION OF THE SOCIAL SCIENCES IN CANDI-
DACY FOR THE DEGREE OF DOCTOR OF PHILOSOPHY.

DEPARTMENT OF ECONOMICS
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By
R. CRAIG McIVOR

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MODERN war has frequently been described as "total" war. While such a description may not be precisely meaningful, it serves to emphasize the magnitude of the social changes which are now inevitably associated with a major war effort. Modern war has been well described as an industrial art, whose effective prosecution necessitates fundamental alterations in the manner of operation of the democratic peace-time economy.

The basic problems which confront a country in time of war may be classified as follows:¹ (1) producing the goods and services necessary for carrying on the war; (2) paying for the goods and services used for war purposes; (3) supplying the everyday needs of the civilian population. While it is with the second problem, that of financing the war effort, that we shall be directly concerned in this paper, the fundamental and most immediate problem is that of production, to which all others must always be subordinated. Because of the enormous technological advances in the methods of modern warfare, World War II presented all of these problems on a scale vastly greater than ever before.

In time of war there occurs a revaluation of social ends, and maintenance of the state itself becomes the supreme social objective. To accomplish this objective under conditions of modern warfare, it is essential that the organization and expansion of war production be accomplished with the utmost possible speed. This point was well illustrated by the experience in World War II, where the problem of mobilizing the required quantities of productive resources was extremely complex, and where various nations with superior economic war potentials found themselves in imminent danger of suffering defeat before their full economic strength could be directed effectively against the enemy. Under these circumstances, where speed is the essence of effective economic mobilization, the sudden demand for an ever-increasing quantity and variety of war goods and services is likely to be highly inelastic, since the needs must be satisfied, if at all possible, regardless of price. But in the short run, supply is also relatively inelastic, and the government consequently finds itself confronted with immediate problems of procurement.²

Within the Canadian economy, World War II occasioned the development of an unprecedented volume of direct governmental controls, i.e., measures which interfered with the freely operating price system and which restricted the individual's freedom of economic choice. These controls were introduced in piecemeal fashion as the war progressed, being dictated by the exigencies of the immediate situation. In the early stages of the conflict, monetary expansion was the chief device adopted by the government in carrying out its economic war policies. Subsequently, the major emphasis was transferred to

¹For a discussion of these problems, see Chester W. Wright, "Economic Lessons From Previous Wars" (in *Economic Problems of War and its Aftermath*, ed. by Chester W. Wright, Chicago, 1942).

²See T. O. Yntema, "Price Controls," *ibid.*, p. 112.



fiscal measures.³ But as war-time demands upon the economy continue to expand, monetary-fiscal policy is by itself incapable of effecting the adequate restriction of the civilian use of resources, and more positively, of guaranteeing the production of war materials of the kinds and quantities required. For this reason, the third stage in the transition of the Canadian economy to a war basis was marked by the greatly extended use of selective controls, in conjunction with appropriate fiscal policy.⁴

In the early months of the war the demands upon the Canadian economy were not great, and although the prospects of a lengthy conflict were clearly seen and frequently emphasized, the necessity for the all-out economic war effort which later developed was not immediately apparent.⁵ For this reason, Canada passed through two distinct periods in the war-time mobilization of her economic resources. At the outbreak of war, a very considerable amount of unused productive capacity and of unemployed resources existed, a situation which prompted the government to observe that it should be possible to develop a great deal of production for war purposes without causing any serious temporary reduction in existing standards of living.⁶ No appreciable re-allocation of resources was required before mid-1940, because the increased demands upon the economy were for commodities ordinarily produced in peace-time in Canada, the output of which could be expanded by the use of existing unemployed resources. A general "business-as-usual" attitude prevailed throughout the economy during this period. It was not until the collapse of France in June, 1940, that the urgent necessity for an all-out war effort became apparent, whereupon intensive development of the war economy was undertaken. The subsequent demand for various kinds of war material and equipment necessitated a rapid expansion of Canada's productive capacities, and as the zone of full employment was approached, the need for re-allocation of productive resources became increasingly apparent. The "business-as-usual" attitude quickly disappeared and the economy was increasingly subjected to selective governmental controls.

For reasons already noted, it was not possible in the early months of the war for the Canadian government to make any detailed calculation of the financial burden involved, for the turn of events after June, 1940, presented the government with financial problems whose magnitude had not originally been foreseen. Canada's war-time expenditures included not only the outlays involved in meeting its own direct war-time needs, but extended to the

³War-time fiscal policy must of course be determined not only in the light of its economic desirability but also in terms of its political acceptability. If fiscal measures hitherto considered drastic are to be successfully introduced, the public must first be taught to recognize their necessity. The Canadian deputy minister of finance believed that one of the good things about the war was that it led to a process of general economic education.

⁴For a summary of the failings of the competitive price system in the war economy, see Stewart Bates, "The Price System and the War Economy" (*Canadian Journal of Economics and Political Science*, vol. VII, 1941, pp. 333-4).

⁵For an explanation of the lack of industrial mobilization during the early months of the war, see R. MacG. Dawson, *Canada in World Affairs, 1939-1941* (Toronto, 1943), pp. 16-17, 116.

⁶See A. F. W. Plumptre, *Canadian War Finance, 1939-1940* (Washington, 1941), pp. 8-68.

financing of purchases made within Canada by Great Britain, by various other members of the sterling bloc and by other Allied nations. The financing of these war-time expenditures created problems both of a quantitative and qualitative character.⁷

The particular functions of an adequate programme of war finance may be summarized as follows: (1) providing the funds for meeting the enormous war-time expenditures; (2) restricting the civilian demand for resources in order that these may be made available, as needed, for war purposes; (3) allocating the economic burden of the war as equitably as possible. While providing the necessary funds is undoubtedly the most obvious aspect of the programme of war finance, it was the view of the Canadian government that the second aspect was of basic importance. It was stated that "behind this facade of dollars, the real work of war finance is to draw the resources of the country into use for war purposes and away from other uses, or from idleness. This is the initial and general economic problem; finance is the main instrument of achieving a solution. . . . it is in making these resources of men, materials and machines, available that the real task of finance must be found."⁸

Immediately prior to World War II, at least one American economic historian, writing in a country where the necessity for undertaking war finance had occurred more frequently than in our own, expressed the opinion that discouragingly little had been learned about such matters from past experience.⁹ This view would perhaps now be modified in the light of more recent accomplishments. With reference to our own experience in World War II, it was clear from the outset that the Canadian government possessed a sound conception of the functions which should be performed by its programme of war finance. The continuous development of that programme, as hereinafter outlined, was such that its objectives were accomplished to a degree not surpassed by any of the other major belligerents.

Almost all past conflicts have been accompanied by an undesirably large amount of inflationary financing. An important contributing factor, one associated with the third function of war finance, has been the erroneous belief that, unlike taxation, domestic borrowing affords an opportunity for shifting some part of the cost of the war to future generations. While it is true that under certain circumstances, future generations may be called upon to bear some part of the real costs of a conflict, e.g., through the diminution of the productive capacity of the economy as a result of the war, this occurrence is obviously independent of the means adopted in financing the conflict. It is surely apparent that the real cost of a war is incurred by using resources for purposes of destruction which would otherwise have been available for constructive ends. The significance of the taxation-versus-borrowing controversy lies in determining how the burden of a present war will be distributed within the existing generation, and how the real income of future generations will be distributed among its own members.¹⁰

⁷See note on Foreign Exchange Control Board, *infra*.

⁸J. L. Ilsley, *House of Commons Debates*, July 30, 1940.

⁹See Wright, "Economic Lessons from Previous Wars."

¹⁰*Ibid.*

The Canadian government recognized that in a war which was to be financed almost exclusively from domestic sources, the real costs would inevitably be borne by the citizens currently involved in the conflict. A fallacious argument that had so greatly influenced the financing of earlier wars was consequently avoided.¹¹ Discussing its programme of war finance, the government repeatedly presented the view that there were three methods of financing a war, these being taxation, borrowing, and inflation.¹² This three-fold division may be very useful in emphasizing the possible ways of restricting civilian consumption. If, however, it is used to emphasize alternative sources of government funds, it becomes very misleading, for expenditure from borrowings, and even from the proceeds of taxes may have inflationary consequences.

In formulating its general principles of war finance, the government discarded the third member of the "trinity," inflation (the creation of new money), as being certainly the most unfair and inequitable method of diverting resources to war-time ends. It consequently directed its attention to the other two sources of funds, taxation and borrowing. The minister of finance indicated in his first war-time budget speech that while a 100 per cent pay-as-you-go policy might seem to represent an ideal policy of war finance, being most logical, most equitable, and least likely to create disturbances and dislocations, there were certain well-recognized limitations upon any programme of taxation. Accordingly, the government adopted a policy of war finance in which the pay-as-you-go objective was to be pursued to the limits of practicality; additional financial needs were to be met by a programme of borrowing from the public at the lowest possible interest rates. An equitable distribution of the economic burden of the war was to be encouraged "first by avoiding inflation, second by anti-profiteering measures, third by using taxes rather than loans as a source of war revenues, fourth by use of direct taxation the incidence of which is relatively predictable, and fifth by concentrating the burden on groups which had previously escaped relatively lightly."¹³

In applying its financial measures, the government distinguished two major periods in the development of the war economy. The first was the period of expansion and preparation, the second the main period of the full war effort. In the initial period, it was announced that a short-run policy of financing would be adopted which would differ substantially from the basic policy noted above. The minister of finance stated that in view of the existing quantities of unemployed resources and unused productive capacity, a small and carefully regulated amount of credit expansion was desirable in promoting increased production and employment, and that such an expansion could be ac-

¹¹See J. L. Ilsley, *Budget Speech*, Sept. 12, 1939, p. 3.

¹²In referring to "inflation" as one source of war finance, the government usually meant the creation of new money; this terminology at least clarifies the basis for the government's threefold division of the sources of funds—taxes, loans from current income, and new money. For a much more satisfactory classification of the instruments of war-time fiscal policy, according to their expansive or contractive influences upon the economy, see A. F. W. Plumptre, "An Approach to War Finance" (*Canadian Journal of Economics and Political Science*, vol. VII, 1941, pp. 1-12).

¹³A. F. W. Plumptre, *Canadian War Finance, 1939-1940* (Washington, 1941), p. 111.

complished without inflationary consequences. The government recognized that in introducing subsequent measures of taxation and borrowing, the matter of timing would be important, in relation to their effects upon the accomplishment of the desired economic expansion. Thus, at the outbreak of the war, the immediate expansion of tax revenues was neither possible nor considered altogether desirable, and a borrowing campaign designed to attract public savings was not believed to be appropriate at that time, since it might impede expenditures by private industry and interfere with civilian consumption which the government was seeking to expand. Short-term bank borrowing was therefore adopted as the most effective means of stimulating the early development of the war programme, and of expanding employment and output. At the same time, the probability of much heavier expenditures was foreseen, and the government accordingly emphasized the need for the immediate imposition of various additional taxes, the yields from which would not appear for some considerable time.

A survey of the various forms of direct controls which were adopted by the government as part of its programme of war-time economic mobilization is not within the scope of this paper, and the development of these controls has been adequately discussed elsewhere. With the exception of the Foreign Exchange Control Board, whose organization and functions had been the subject of advance planning, and which could consequently be put into operation when war was declared, all administrative controls were introduced into the economy on a more or less *ad hoc* basis. The administrative control exercised by the Foreign Exchange Control Board is of special interest, however, because it represented the outstanding instance of direct intervention in war-time monetary affairs, and a brief summary of the Board's activities is therefore desirable.

The establishment of the Board on September 16, 1939, marked the first occasion on which any official restrictions had been placed on foreign exchange transactions within Canada. The Foreign Exchange Control Order gave the Board control over all financial transactions between residents of Canada and residents of other countries, the essential objective being "to maintain exchange stability and to conserve Canada's supply of United States dollars for essential war and civilian requirements by ensuring that it was not dissipated on non-essential purposes such as capital export."¹⁴ The necessity for conserving United States dollars was directly related to the structure of the Canadian balance of payments. Following the formation of international currency blocs in the nineteen-thirties, Canada found her external trade closely tied to both the sterling area and the United States dollar area. Her substantial over-all current account surplus in the years preceding World War II was the product of a recurring net deficit with the dollar area and a recurring net credit with the sterling area. Under the existing multilateral exchange system, this situation presented no special problem, since Canada could convert her surplus sterling into United States dollars, and thereby cover her dollar deficit. With the advent of World War II, the government of the United

¹⁴Louis Rasminsky, "Foreign Exchange Control in Canada: Purposes and Methods" (in *Canadian War Economics*, ed. by J. F. Parkinson, Toronto, 1941, pp. 1-16).

Kingdom instituted exchange control to protect its own dollar reserves, and with sterling no longer freely convertible, Canada found her balance of payments effectively split into two parts. It therefore became necessary for her to consider her financial relationship with the United States on an independent basis.

It was immediately apparent that war-time developments would accentuate the United States dollar deficit of the pre-war years, for as Canada sought to expand and diversify her capacity for war production, both on behalf of herself and of her allies, increased capital outlays in the United States would become inevitable. To conserve United States dollar reserves for these and other essential uses, foreign exchange control was introduced. At the beginning of World War II, the investment of United States capital in Canada amounted to \$4.2 billions.¹⁵ In the absence of restrictions on capital transactions, any appreciable attempt to liquidate and convert investments by non-resident holders would have had disastrous effects upon Canadian reserves of United States dollars. Restrictions on current transactions were also inevitable if an expanding Canadian national income were not to stimulate undesirably the import of relatively non-essential consumers' goods and to encourage an expansion of their domestic production. A further objective of exchange control was the elimination of the disturbing fluctuations of a "free" exchange rate, fluctuations which the currency experience of the nineteen-thirties had frequently shown to be of a disequilibrating character.

The Foreign Exchange Control Board was established as the administrative body charged with enforcing the provisions of the Foreign Exchange Control Order. The Bank of Canada became the technical adviser to the Board, and all branches of the Canadian chartered banks became its agents. The chief provisions of the order were that (1) all foreign exchange received by Canadian residents must be sold to the Board through an authorized dealer (on April 30, 1940, it was further provided, under the terms of the Foreign Exchange Acquisition Act, that these residents must sell to the Board all foreign exchange in their possession, ownership, or control at the time); (2) Canadian residents must apply to the Board for any foreign exchange which they required; (3) transfers of Canadian dollars by residents to non-residents might be made only under permit. The Board was also authorized to establish rates of exchange for all foreign exchange transactions within Canada.

The original capital resources made available to the Board for conducting its operations were represented by a special Exchange Fund Account which had been established in 1935, the proceeds of which amounted to \$84 million at the beginning of the war, held entirely in Canadian funds. The government made subsequent advances to this fund, the first being on May 1, 1940, in the amount of \$325 million, to provide the Board with the means of payment for the gold and foreign exchange which it acquired under the terms of the Foreign Exchange Acquisition Order and the Exchange Fund Order. At the end of 1945, outstanding advances to the fund amounted to \$1.3 billion.

¹⁵Foreign Exchange Control Board, *Report to the Minister of Finance* (Ottawa, 1946), p. 7.

Concerning Canada's relations with the sterling area, transactions could be effected either in Canadian dollars or in sterling, and no restrictions were placed upon payments to the sterling area in either currency. No import licences were required for goods originating in the sterling area. Sterling area residents wishing to sell securities in Canada were required to obtain permits which were granted without question where it could be shown that the dollar proceeds would be made available to the sterling area exchange control authorities. These authorities controlled all payments by the sterling area to Canada, and capital transactions were generally not approved.

The financing of the United Kingdom's Canadian-dollar deficit involved a variety of techniques. Among the most important were the repatriation of Canadian securities held in the United Kingdom, the accumulation of sterling balances in London which were later converted into an interest-free loan, and the appropriation of funds under the terms of the War Appropriation (United Nations Mutual Aid) Acts. The immediate financial burden of each of these techniques of course fell upon the Canadian taxpayer.

Despite early attempts to increase Canadian exports to the United States, to encourage increased United States investment in Canada, and despite severe restrictions upon the non-essential uses of United States dollars by Canadian citizens, Canada's exchange position vis-à-vis the United States became increasingly serious in 1941. The situation was effectively eased only with the completion of the Hyde Park Agreement in April of that year. From that date until the end of the war, Canada's holdings of gold and United States dollars steadily rose, exceeding \$1.5 billion at the end of 1945.¹⁶

Aside from the administrative activities of the Foreign Exchange Control Board, the principal device employed by the government to facilitate war production in the early months of the war was that of monetary expansion. The second war-time budget in June, 1940, marked the effective beginnings of fiscal control, and this was increasingly supplemented by more direct measures, of which the most outstanding was the shift from selective to overall price control late in 1941.

Before discussing war-time financial developments, it is desirable to note briefly some of the features of earlier federal financing. During the decade of the nineteen-twenties, the annual expenditures of the federal government were relatively stable, and amounted to less than 10 per cent of the national income. However, the advent of the depression introduced an entirely new situation, in which the national income declined rapidly at a time when the assumption of increasingly heavy obligations by the federal government was becoming unavoidable. A balanced budget was no longer possible, and the national debt began to rise more rapidly than at any time in Canadian history, with the exception of the World War I years.¹⁷ Although economic conditions had improved appreciably by the late nineteen-thirties, the government was still operating with an unbalanced budget at the beginning of World War II. As

¹⁶*Ibid.*, p. 20.

¹⁷For the growth of the national debt since Confederation, see *Public Accounts, 1939*, p. 64. The only period in which the debt showed annual reductions was between 1923 and 1930.

of March 1, 1939, the total unmatured funded debt including treasury bills outstanding was approximately \$3,386 million, with an average rate of interest of 3.52 per cent.¹⁸ As already suggested, the size of the debt was largely attributable to the exigencies of financing both a war and a depression, and represented a tenfold increase since 1914. In addition to this direct debt, the government had incurred various indirect obligations, chiefly in connexion with the guarantee of the securities of various railroads which now form the Canadian National system. The total amount of these contingent liabilities, as of June, 1939, was approximately \$1,085 million, an amount which was steadily reduced during the war years.¹⁹

It will subsequently be observed that one of the accomplishments of the federal tax measures introduced during World War II was to lessen the regressiveness of the Canadian tax system. The manifold defects of the system have been discussed with increasing frequency by students of public finance, and here we wish only to indicate one aspect of its operation, that of the relative importance of the various sources of current revenue for the federal and provincial governments at the outbreak of World War II. For the combined provincial governments, corporation taxes, personal income taxes, and succession duties yielded 32 per cent of revenues, commodity taxes and licenses 55 per cent, and real property taxes plus revenue from public domain 13 per cent. For the federal government, commodity taxes yielded 67 per cent and income taxes 33 per cent.²⁰ Since the British North America Act restricts the taxing power of provincial governments to the levying of "direct" taxes, one may well question the usefulness of that term as an economic concept.

In the 1939 fiscal year, the overall cash requirements of the federal government approximated \$512 million, 88 per cent of which was met by taxation and other revenue. These cash requirements represented about 10 per cent of the Canadian gross national product at market prices. The heavy financial burden imposed by the war led to a very rapid rise in this proportion, and we now direct our attention to the methods adopted by the government in financing its rapidly increasing expenditures, and to the consequences of those methods.

In his first war-time budget speech, the minister of finance indicated the desirability of undertaking monetary expansion, of introducing new taxes, and of increasing the rates of existing taxes. It was not believed that these tax measures would provide immediately for any large part of the government's rapidly increasing expenditures, but that out of an anticipated rising national income, increased tax revenue would soon begin to appear. Meanwhile, to meet the inevitable deficit of this early period, short-term expansionist borrowing would be undertaken. It is clear that to the end of March, 1940, little additional tax revenue was realized from the new tax measures.²¹ Nor was it intended that these measures should lead to an appreciable restriction of

¹⁸*Ibid.*, pp. 20-1, 68.

¹⁹Bank of Canada, *Statistical Summary*, June-July, 1939, p. 11.

²⁰Bank of Canada, *Statistical Summary*, 1946 *Supplement*, p. 46.

²¹See the *Public Accounts*, 1939, pp. xii-xiii; *Public Accounts*, 1940.

TABLE I
SELECTED FEDERAL FUNDED DEBT OPERATIONS: WORLD WAR II*
(millions of dollars)

Fiscal Year	1940†	1941	1942	1943	1944	1945	1946
A. Sources of New (Cash) Borrowing‡							
General Public§							
First War Loan	200						
Second War Loan		300					
First Victory Loan			731				
Second Victory Loan			843				
Third Victory Loan				991			
Fourth Victory Loan					1309		
Fifth Victory Loan					1375		
Sixth Victory Loan						1405	
Seventh Victory Loan						1512	
Eighth Victory Loan							1564
Ninth Victory Loan							2024
War Savings Stamps and Certificates	—	52	82	59	47	29	10
Non Interest Bearing Certificates	—	6	3	—	1	2	**
Chartered Banks	200	250	—	820	170	112	**
Bank of Canada	—	325	—	193	—	—	—
Treasury Bills	—	75††	40	30	60	20	70
Total New Borrowing Within Canada.....	400	933	1699	2093	2962	3080	3668
New York Market	—	—	10	90	—	—	—
TOTAL NEW BORROWING....	400	933	1709	2183	2962	3080	3668
B. Retirements							
New York	—	—	20	110	106	—	155
London	84	147	160	3	‡‡	—	—
Canada	100	110	36	42	60	252	761
TOTAL RETIREMENTS.....	184	257	216	155	166	252	916
C. Increase in Direct Funded Debt							
Net Borrowing	216	676	1493	2028	2796	2828	2752
Refundable Tax Liability	—	—	—	70	155	219	71
Accounting Adjustment***	—	—	—	23	—	—	—
TOTAL INCREASE IN FUNDED DEBT.....	216	676	1493	2121	2951	3047	2823
D. Direct Unmatured Funded Debt, at March 31	3696	4372	5865	7986	10937	13984	16807
E. Average Interest Rate Payable on Debt	3.40	3.06	2.90	2.60	2.55	2.51	2.49

*The data in the above table are based on Dominion of Canada, *Public Accounts*, for the several war-time fiscal years; *Budget Speeches*, for the several fiscal years; National War Finance Committee, *Statistics and Information on Dominion Government Public Borrowing Operations From September 1939 to December 1945* (Ottawa, 1946).

†From September 1, 1939 to March 31, 1946 only.

‡Excludes renewals, and the conversion of maturing issues.

§Excludes the chartered banks and the Bank of Canada. The direct cash purchases of public issues by the banking system were of negligible amount.

||Net increase during the fiscal year.

**Net retirement during the fiscal year, which in the case of the non-interest bearing certificates amounted to \$6 million, and of the chartered banks to \$260 million.

††Included in the purchase of \$325 million by the Bank of Canada.

‡‡In 1944 and succeeding fiscal years, the repatriation from Britain of the direct funded debt was of negligible proportions.

||||Arising from personal income tax and excess profits tax revenues.

***This adjustment represents the inclusion in the debt, for the first time, of the premium at which certain of the funded debt issues were redeemable. Previous to this adjustment, the debt, as of March 31, 1943, had been determined as \$7,893 million. Beginning with the 1944 fiscal year, these redemption bonuses were added to the figure representing the debt outstanding. On this revised basis, the 1943 figure would read \$7,916 million. A further modification of accounting practice in 1944 was the inclusion of the refundable portion of income tax revenues in the debt figure. This portion amounted to \$70 million in 1943, providing an overall debt figure of \$7,986 million as of March 31 of that year.

consumption while substantial unemployment still prevailed within the economy. The chief features of the tax programme introduced in the first war budget were: a new excess profits tax on all business; a flat-rate increase of 20 per cent in the personal income tax; an increase of 3 per cent in the corporation income tax; sharp increases in excise taxes and in the tariffs on tea and coffee; a new tax on the ingredients of soft drinks, and a widening of the base of the sales tax.²² For the entire 1940 fiscal year, the increase in total tax revenues over the preceding year was only \$32 million, this being attributable to increases in yields from customs duties, the sales tax and excise levies.²³ This additional revenue provided only a relatively small proportion of the increase in total cash requirements of the government during the first seven months of the war, an increase which amounted to \$251 million.

During the entire 1940 fiscal year, the total cash requirements of the federal government had amounted to \$763 million. The total of revenues plus borrowing, \$885 million, represented approximately 16 per cent of national income. Of this total, revenues provided 55 per cent, borrowings 45 per cent, and it is apparent that a substantial increase in cash balances was realized by the government during the year.²⁴

The Bank of Canada determined its war-time monetary policies in close relationship to the government's changing fiscal needs, and continued to employ open-market operations as its chief means of control throughout the war. In addition, the organization of the chartered banks made the device of informal suggestion particularly effective. In its efforts to further economic

²²For the detailed tax measures, see J. L. Ilsley, *Budget Speech*, Sept. 12, 1939, pp. 6-11.

²³*Public Accounts*.

²⁴Bank of Canada, *Statistical Summary*, June-July, 1946, pp. 51-2.

revival, the Bank of Canada had followed an easy-money policy since its inception in 1935. One of the immediate objectives of the Bank's monetary policy following the outbreak of the war was to provide the chartered banks with additional reserves to permit their purchase of an issue of government securities, in accordance with the monetary views expressed in the budget. In so doing, the Bank was merely continuing its earlier fundamental policy of credit expansion. Since the chartered banks have traditionally sought to maintain a 10 per cent reserve against their Canadian deposit liabilities, open-market operations served as an effective weapon whereby the central bank might influence the supply of money.

The sources of cash borrowed by the federal government between the outbreak of the war and the end of the 1940 fiscal year may be seen from Table I. The issue to the chartered banks reflected the policy of deliberate monetary expansion which was pursued in the early stages of the war. It will be observed that in no war-time fiscal period was net borrowing effected abroad, for on the two occasions on which new funds were obtained in the New York market, the proceeds were used to assist in retiring maturing issues of substantially greater amount. Through the process of repatriation, the direct funded debt payable in London was virtually eliminated, and as a result of the net retirements effected during the war years, approximately 99 per cent of Canada's direct debt was domestically held, as of March 31, 1946.

The impact of war finance upon the banking system is revealed by Table II and Table III, which present annual data of the assets and liabilities of the Bank of Canada and of the chartered banks, respectively. These data also provide the basis for Table IV, from which changes in the war-time money supply may be analysed. A rapid increase in the Bank of Canada's active note circulation began in the early months of the war. Apart from normal seasonal increases, and the continued replacement of chartered bank notes, factors underlying the expansion included the growing national income, changing methods of income payments and the disappearance of United States dollars from circulation. The expansion of notes relative to that of deposits was pronounced during the war years. The most important basis for the increase in the circulating medium during the 1940 fiscal year was the \$200 million cash loan which was purchased by the chartered banks. Excluding minor changes in the amount of subsidiary coinage, the total quantity of money ($M + M^1$) increased by \$227 million during the first seven months of the war, and by \$274 million during the entire fiscal year, and stood at \$3,049 as of March 31, 1940.²⁵

It is obvious from Table III that an important effect of war finance upon the chartered banks was the expansion of deposits based upon their purchases of government securities, these purchases being made possible by appropriate open-market operations by the Bank of Canada. The demand for war-time

²⁵For a discussion of the velocity of circulation of the Canadian money supply, see D. C. MacGregor, "The Problem of Price Level in Canada" (*Canadian Journal of Economics and Political Science*, vol. XIII, 1947, and particularly pp. 186-92).

TABLE I
BANK OF CANADA: WAR-TIME CHANGE
(millions of dol

	LIABILITIES								
As of March 31	Chartered Bank Cash			Gov't Deposits	Other Deposits	Special Foreign Deposits (†)	Active B. of C. Note Circulation	All Other Accounts	T Ass Lial
	Notes in Tills	Deposits at B. of C.	TOTAL						
1940	57.3	202.3	259.7	48.0	10.6	—	163.8	11.9	4
1941	80.6	208.0	288.6	17.1	8.3	—	284.7	13.4	6
1942	99.1	241.9	341.1	118.8	6.1	—	409.8	16.3	8
1943	108.7	261.0	369.7	21.2	24.7	—	610.4	19.4	10
1944	100.3	359.2	459.5	65.8	22.8	—	797.6	44.5	13
1945	113.4	422.0	535.4	18.7	52.7	177.1	935.4	26.3	17
1946	124.7	518.1	642.9	149.2	89.1	95.2	977.5	36.9	19

*The data in Table II are gathered from the Bank of Canada, *Statistical Summary, 1946 Supple*
†Deposits payable in sterling, U.S. dollars, and foreign gold currencies, held on account of fore
‡Includes foreign exchange held on account of foreign clients.
§Includes "other securities."
||Under the Foreign Exchange Acquisition Order and the Exchange Fund Order, the Bank's go

TABLE II
CHARTERED BANKS: WAR-TIME CHANGI
(millions of dol

As of March 31	LIABILITIES							Ca i Car (
	Notes	DEPOSITS						
		Demand	Notice	Dominion and Provincial	Canadian Deposits (†)	Foreign	Total Deposit (‡)	
1940	92	750	1661	313	2734	467	3262	20
1941	83	1050	1703	219	2958	411	3447	20
1942	74	1144	1550	611	3302	473	3843	30
1943	55	1659	1890	268	3750	550	4443	30
1944	40	1892	2225	251	4340	666	5140	40
1945	31	1935	2725	279	4938	739	5792	50
1946	24	1985	3170	626	5786	800	6712	60

*The data in Table III are gathered from Bank of Canada, *Statistical Summary, 1946 Suppleme*
†Estimated month-end deposits payable in Canadian currency.
‡Includes inter-bank deposits.
§Until March, 1935, this included gold and coin in Canada, Dominion notes and "free" centra

ASSETS AND LIABILITIES *

(in millions of dollars)

ASSETS

Total Assets or Liabilities	Gold	Reserve Foreign Currency (\$)	Total Reserve (\$)	SECURITIES			All Other Assets
				Dom.-Prov. Under 2 Years	Dom.-Prov. Over 2 Years	Total (\$)	
94.0	225.8	60.7	286.5	93.4	104.7	198.0	9.5
12.1	(11)	69.5	69.5	411.1	114.5	525.6	17.0
92.0		276.3	276.3	866.3	209.4	596.0	18.7
145.4		0.3	0.3	752.5	276.4	1028.9	16.2
90.1		0.3	0.3	788.9	557.0	1345.9	44.0
145.5		177.1	177.1	926.5	608.7	1545.2	23.2
90.8		95.2	95.2	1296.2	559.9	1866.1	29.4

ment, pp. 6-9, and *Statistical Summary*, Apr.-May, 1947, pp. 33-4.
sign clients.

ld and foreign exchange holdings were sold to the Foreign Exchange Control Board.

ASSETS AND LIABILITIES *

(in millions of dollars)

ASSETS

Cash in Canada (\$)	SECURITIES				LOANS			Total Assets
	Under Two Years	Over Two Years	Other	Total	Canada		Abroad	
					Call	Current		
30	606	704	289	1599	52	1115	199	3715
39	740	787	240	1766	35	1114	182	3910
41	724	920	237	1881	34	1300	191	4352
70	1657	715	317	2689	24	1003	193	4914
59	1796	1010	349	3156	41	982	206	5589
35	1878	1326	402	3606	78	1094	211	6249
40	1671	2028	497	4197	148	1181	255	7193

nt, pp. 16-19, and *Statistical Summary*, Apr.-May, 1947, pp. 35-6.

gold reserve deposits; after that date, Bank of Canada notes and deposits.

TABLE IV
THE MONEY SUPPLY OF CANADA: 1940-6*
(millions of dollars)

	Volume of Canadian Money							Changes in Volume in Fiscal Year						
	1940	1941	1942	1943	1944	1945	1946	1940	1941	1942	1943	1944	1945	1946
As of March 31														
Notes held by the General Public														
Bank of Canada	164	285	410	610	798	935	978	51	121	125	200	188	137	43
Chartered Banks	92	83	74	55	40	31	24	-5	-9	-9	-19	-15	-9	-7
TOTAL.....	256	368	484	665	838	966	1002	46	112	116	181	173	128	36
Deposits with the Chartered Banks														
Public Demand	750	1050	1144	1659	1892	1935	1985	45	300	94	515	233	43	50
Public Notice	1661	1703	1550	1890	2225	2725	3170	-39	42	-153	340	335	500	445
Other Canadian†	323	205	608	201	223	278	431	190	-118	403	-407	22	55	153
TOTAL.....	2734	2958	3302	3750	4340	4938	5586	196	224	344	448	590	598	648
Deposits with the Bank of Canada														
Dominion Government and other†	59	25	125	46	88	71	238	32	-34	100	-79	42	-17	167
TOTAL VOLUME OF MONEY....	3049	3351	3911	4461	5266	5975	6826	274	302	560	550	805	709	851

*The data in Table IV have been compiled from Table II and Table III. Subsidiary coinage is excluded from the above figures.

†Variations in this item are accounted for mainly by variations in Dominion government deposits.

‡Excludes chartered bank deposits with the Bank of Canada, and deposits in foreign currencies.

credit was predominantly from the government, the volume of commercial loans remaining relatively stable. In particular, the financing of private enterprise engaged in war production was in considerable measure accomplished directly through the use of the accumulated reserves of those expanding business organizations. Much additional financing of war industry was carried on through direct government action in the establishment of Crown corporations. The practice of loaning funds by government agencies to private business was not employed as a means of financing war industry.

While the increase in the ratio of the holdings of government securities to total assets was a war-time feature of chartered bank operations, it was also characteristic of the Bank of Canada, as shown in Table II. Through its open-market operations, which served both to increase the reserves of the

chartered banks and to support the price of government securities, and through its direct purchases of securities from the government, the Bank came to hold an overwhelming proportion of its total assets in the form of securities. As for its liabilities, the chief increase was in active note circulation, attributable to causes already noted. By the end of the war, the deposit structure of the country was closely related to the federal debt, a situation which is important in terms of the future economic stability of the country.²⁶

The increase in the quantity of money during the early months of the war was, as already indicated, attributable almost entirely to the government's deliberate adoption of an expansionist policy. But this policy was desirable only in the short run, and the basic fiscal policy soon to be adopted was one which constantly endeavoured to minimize monetary expansion. To the extent that tax revenues fell short of meeting the increased financial needs of the government, public borrowing from the current income of the moderate and lower income groups was to be the main objective sought. The commercial banks were to serve as a secondary reserve of borrowing, while the Bank of Canada would be approached as a last resort, to meet any residual needs of war-time finance.

Speaking early in the 1941 fiscal year, the minister of finance stated that with considerable unemployment still prevalent, the object of financial policy would be to ensure the diversion of as large a proportion as possible of the increasing national income to war-time ends, while at the same time leaving sufficient stimulus to bring the country to full employment at the earliest possible time.²⁷ The total cash requirements during fiscal year 1941 amounted to \$1,850 millions, of which 43 per cent came from taxation and other revenues, 51 per cent from borrowing, and the remaining amount from a decrease in the government's cash balances.²⁸ These requirements represented 28 per cent of the expanding national income, a proportion which reflected the increased tempo of the war effort after mid-1940, when for the first time, the real dimensions of World War II were becoming apparent. The greatly increased financial burden arose both from the expenditures involved in furthering Canada's own direct war effort, and from the financial assistance accorded to Allied countries. This latter category included not only the repatriation of British-held securities, but also substantial loans to the Foreign Exchange Control Board. Non-war expenditures were substantially decreased during the year.

Many of the new tax proposals did not involve immediate payment, and many of the calculated increases in tax revenues were not to occur until the subsequent fiscal year. Expansionist financing was continued, since it was felt that under the existing circumstances inflationary results would not appear, and that undue monetary stringency should be avoided. For despite the frankly expansionist policy that had been pursued since the outbreak of the war (even the *public* borrowing operations having been of this character,

²⁶See Charles R. Whittlesey, "Problems of Our Domestic Money and Banking System" (*American Economic Review*, vol. XXXIV, 1944).

²⁷See J. L. Ralston, *Budget Speech*, June 24, 1940, p. 5.

²⁸Bank of Canada, *Statistical Summary*, June-July, 1946, pp. 51-2.

with many of these funds coming from idle savings), the increase in real income to this time had been such as to prevent inflationary results, and it was felt that similar success could be maintained for some little time longer.²⁹

The principal tax measures introduced in this period reflected the intention of the government to place its chief reliance upon direct taxation as the source of increased revenues, and to concentrate the burden upon the lower and middle income groups. For reasons both of equity and of expediency, the increases in indirect commodity taxes were to be minimized.³⁰ The chief measures included a 10 per cent war-exchange tax on all imports from non-Empire countries, a major objective being the conservation of exchange; a tax applied to sales by manufacturers and importers of automobiles, which was also designed to conserve exchange and to restrict civilian production in that industry; a new Excess Profits tax on industry, being 12 per cent of total profits or 75 per cent of excess profits, whichever was the greater; sharp increases in personal income taxes through a general upward revision of rates and a lowering of tax-free exemptions; a new flat-rate National Defence Tax of 2 per cent or 3 per cent, according to status and income; substantial increases in excise taxes levied on various "luxuries"; the only significant tariff changes were those designed to offset the additional excise taxes.³¹

The desire for continued monetary expansion was reflected in the funded borrowing operations effected during the 1941 fiscal year. Table I shows that both the Bank of Canada and the chartered banks made substantial cash purchases of new government securities. In addition, the banking system bought a small amount of the Second War Loan, the Bank of Canada providing about \$19 million and the chartered banks \$1 million. The sale of war savings certificates and stamps, and of non-interest-bearing certificates was introduced during this year. The government was anxious to tap even the smallest sources of savings effectively and regularly, since such funds represented, in large measure, allocations from current income. The last-mentioned security was made available for those persons who wished to provide funds, without cost to the government, for prosecuting the war. The sale of Treasury bills to the Bank of Canada represented the net increase in their amount outstanding, and was the first of only two occasions during the entire war when these securities were sold directly to the central bank.

The chief purpose of the \$325 million subscribed by the Bank of Canada was to provide a loan to the Foreign Exchange Control Board, in order that it might purchase the gold reserves of the Bank of Canada, in accordance with the terms of the Exchange Fund Order of April 13, 1940, and also that it might purchase the foreign exchange required to be sold to the Board by Canadian residents in accordance with the terms of the Foreign Exchange Acquisition Order of the same date.³² Under the terms of the Exchange Fund

²⁹This view did not pass unchallenged. For a summary of the economic objections voiced against a continuation of the policy, see J. F. Parkinson, "Some Problems of War Finance in Canada" (*Canadian Journal of Economics and Political Science*, vol. VI, 1940, 403-21).

³⁰For the changing war-time distribution of total tax collections, see the Bank of Canada, *Statistical Summary*, Apr.-May, 1947, p. 45.

³¹For the details of these tax measures, see J. L. Ralston, *Budget Speech*, June 24, 1940.

³²The original Canadian dollar resources of the Board consisted of the profit arising from

Order, the Bank of Canada sold to the Foreign Exchange Control Board its gold holdings valued at \$226 million. The minimum gold reserve requirements of the Bank were then temporarily suspended. Under the Foreign Exchange Acquisition Order, the Board bought foreign exchange from the Bank to a Canadian dollar value of \$27.7 million. Following the enactment of this latter order, the Bank of Canada's holdings of foreign exchange consisted almost entirely of sterling held for the account either of the federal government or of the Foreign Exchange Control Board, in connexion with its programme of repatriating securities from Britain.

The rapid expansion of the Bank of Canada's note circulation continued during the fiscal year. While its holdings of government securities increased by \$327 million (Table II), the major part of the addition arose from the special transaction with the Foreign Exchange Control Board, and afforded no direct basis for the increase of chartered bank reserves. This increase amounted to \$29 million (Table II), and was multiplied approximately tenfold in adding to the supply of money during fiscal year 1941 (Table IV). The total supply of money increased by 10 per cent, and was accompanied by a 16 per cent increase in the index of the physical volume of business during 1940.³³ Recognizing the margin of error associated with these estimates, it seems safe to conclude that monetary expansion was accomplishing its objective of facilitating the expansion of employment and output on a scale such that appreciable inflationary influences could be avoided. The period was near at hand, however, when the growing demands of the war effort necessitated an increased reallocation of resources from civilian to military use. To this time, consumption had shown a substantial increase as war activity had developed.

Considering the entire period from the outbreak of war to March 31, 1941, price rises were irregular and of moderate proportions. The index of wholesale prices rose from 100 (September, 1939) to 118.9, the cost-of-living index from 100 to 107.3.³⁴ It was because of the appearance of a much more inflationary trend in the months immediately following that the government introduced its overall price ceiling in December, 1941, and discarded expansionist finance as a deliberate policy.³⁵ The desired increases in employment had been substantially effected, and increasingly restrictive fiscal measures became ap-

the revaluation of the gold stock of the Bank of Canada in 1935, this being credited to an Exchange Fund. The Fund was not operative until its proceeds were taken over by the Foreign Exchange Control Board at the time of its inception.

³³In determining the changes in the effective supply of money, changes in the velocity of the means of payment must of course be considered. The exchange velocity of "all" bank deposits in Canada showed a small annual increase during the first three years of the war, and a corresponding annual decrease thereafter. To this extent, changes in the means of payment do not correctly reflect changes in the effective supply of money, but in this case, the error is relatively small. For data on velocity of bank deposits, see MacGregor, "The Problem of Price Level in Canada," p. 187.

³⁴*Report of the Wartime Prices and Trade Board* (Ottawa, 1943), p. 68.

³⁵For a discussion of the development of war-time price-control, see K. W. Taylor, "Canadian Wartime Price Controls, 1941-46" (*Canadian Journal of Economics and Political Science*, vol. XIII, 1947, pp. 81-98).

propriate, with the pay-as-you-go policy being pushed to the limits of its practicability.

The rapid expansion of the Canadian war effort was reflected by the fact that in fiscal year 1942, the government's total cash requirements, amounting to \$2,886 million, had increased by 56 per cent from the preceding year. The necessity for further restriction of civilian production was stated by the minister of finance, who pointed out that "we too have now come to the stage where the choice between guns and butter must affect the average man and woman in Canada. We must accept a temporary reduction in our average standard of living if we are to achieve the necessary standard of fighting. We cannot hope to live as well as most of us are used to living and fight a total war at the same time."³⁶ Taxation provided 49 per cent of cash requirements, borrowing 67 per cent, with a consequent substantial increase in cash balances during the year.³⁷ The total share of the national income being diverted by the federal government to war and all other purposes had reached 40 per cent. In seeking to establish higher levels of direct taxation, serious difficulties arose from the lack of uniformity among the tax systems employed by the several provinces. The federal government sought in particular to replace the great variety of provincial income taxes, both corporate and personal, with a few clear-cut heavy federal levies. A temporary agreement was reached with the provinces whereby, in consideration of a pre-determined basis of remuneration, they agreed to vacate the personal income tax and corporate income tax fields for the duration of the war. The federal authorities thereby gained exclusive jurisdiction in those fields.

As already indicated, British government expenditures within Canada contributed appreciably to the financial needs of the latter country. From the outbreak of the war to the end of February, 1942, the sterling area's net deficit of Canadian dollars had grown to \$1,770 million, and had been financed in three ways. In increasing order of importance, these were gold payments from the United Kingdom to Canada, repatriation of Canadian securities held in the United Kingdom, and the accumulation of sterling balances by the Foreign Exchange Control Board in London. The last was by far the most important means of handling this war-time problem, and the accumulated balances had reached \$1,100 million by March 31, 1942.³⁸

Canada's problem of maintaining an adequate stock of United States dollars was becoming extremely difficult, and in fact would have become impossible but for arrangements under the Hyde Park Agreement in April, 1941, after which the urgency of this exchange problem began to recede.

The major sources of additional revenue during this fiscal year were the following: a substantial increase in personal income tax rates, including both the graduated rates and the flat-rate national defence tax; the entry of the federal government into the field of succession duties for the first time, but with clear evidence that it was there to stay; a substantial increase in gift tax rates; an increase in the tax rate payable on interest and dividends to

³⁶J. L. Ilsley, *Halifax Speech*, Oct. 6, 1941.

³⁷Bank of Canada, *Statistical Summary*, June-July, 1946, pp. 51-2.

³⁸J. L. Ilsley, *Budget Speech*, June 23, 1942, p. 3.

non-residents; an increase in the excess profits tax, which for corporations became 22 per cent of total profits or 75 per cent of excess profits, whichever was the greater, and which for partnerships and individuals in business became 15 per cent of total profits or 75 per cent of excess profits; sharp increases in the rates of existing taxes, and heavy new taxes on luxury items, with a further widening of the base of the sales tax. Certain tariff reductions were made to facilitate the entry of exports from the United Kingdom to Canada.³⁹ The yield from the tax system increased by 75 per cent from the preceding fiscal year.⁴⁰

Funded borrowing operations reflected the decision of the government to abandon deliberate monetary expansion. The only cash obtained from the banking system during the fiscal year was in the form of a small \$7 million subscription to the First Victory Loan by the chartered banks.⁴¹ The Bank of Canada's holdings of foreign currency, principally sterling balances, increased by \$207 million (Table II). This asset represented purchases from the Foreign Exchange Control Board on a temporary basis, in order to assist the Board in financing its sterling balances. These purchases tended to increase the cash reserves of the chartered banks, but in each instance the Bank of Canada moved to reduce the expansionist effects by appropriate open-market operations.⁴² The money supply increased by \$560 million, or by approximately 17 per cent during the 1942 fiscal year, the most important bases being the continued expansion of the Bank of Canada's active note circulation, and a very substantial rise in federal government balances, particularly with the Bank of Canada. The official index of the physical volume of business showed an increase of 33 per cent during 1941. This index was of course heavily influenced by the output of goods not available for civilian consumption. The index of wholesale prices had risen from 118.9 to 129.5, and that of the cost-of-living from 107.3 to 114.9 during the last nine months of 1942.⁴³ It was evident that not only must fiscal measures become more restrictive but also that a new system of price control was needed to provide greater support than that afforded by the earlier selective approach, if inflation was to be kept within bounds in subsequent periods when shifts in production, rather than overall increases, would become increasingly important.

Cash requirements in fiscal year 1943 had increased by 60 per cent from the preceding period, and amounted to \$4,745 million. This increase was attributable principally to a billion dollar gift to the United Kingdom and to greatly increased expenditures by the Canadian army. Confronted by the necessity for raising an ever-increasing volume of funds, the minister of finance stated that he had inevitably come to the clear decision that "proposals in this budget must include measures to increase our revenues within the fiscal

³⁹For the detailed tax measures, see J. L. Ilsley, *Budget Speech*, Apr. 29, 1941.

⁴⁰Bank of Canada, *Statistical Summary*, June-July, 1946, pp. 51-2.

⁴¹For the distribution of all public loan issues, classified as to types of purchasers, see National War Finance Committee, *Statistics and Information on Dominion Government Public Borrowing Operations from September, 1939 to December, 1945* (Ottawa, 1946), p. 21.

⁴²See the Bank of Canada, *Annual Report*, 1942, pp. 6-7.

⁴³*Report of the Wartime Prices and Trade Board*, pp. 112-15.

year substantially, at least to the point where our dependence on borrowing will be more nearly within the limits of our current saving; they must provide for increased saving, both corporate and personal; they must also include measures to ensure that the task of contributing to the required increase in current saving is more widely and equitably distributed.”⁴⁴ The year’s financing was such that taxation and other revenues provided 46 per cent of the greatly expanded cash requirements. Borrowing provided an additional 40 per cent and the remaining 14 per cent came from a decrease in cash balances during the year. While the pay-as-you-go policy was being pushed to the limits of practicability, renewed emphasis was placed upon the fact that fiscal policy constituted just one phase of the battle against inflation, others being the price-ceiling, the control and rationing of supplies and the direction of man-power, all four of which were complementary rather than alternative measures.

In the 1943 budget, the personal income tax was again the chief instrument employed in obtaining additional revenues. The national defence tax lost its separate identity, being combined with the graduated income tax into a single assessment, much more steeply graduated than in the preceding year. The assessment applied to incomes of calendar year 1942 but was payable over the period from September, 1942, to August 31, 1943, an undesirable time lag of eight months being involved. The assessment included a “minimum savings” portion which was refundable within three complete fiscal years following the end of the war. Various alternative forms of saving currently being accomplished by the taxpayer, e.g., life insurance premiums, pension-fund payments, etc., were permitted as deductions from the refundable portion of the tax. War-time income taxation, both personal and corporate, reached its highest levels in the 1943 budget. The excess profits tax on corporations was increased to 12 per cent of total profits plus either 10 per cent of total profits or 100 per cent of excess profits, whichever was the greater. On partnerships and individuals in business, the tax became 15 per cent of total profits or 100 per cent of excess profits. These increased rates were applied to income earned after mid-1942, and to all companies taxed at the 100 per cent rate on excess profits, a refund of 20 per cent was to be made after the war. Additional tax measures included an increase in the schedule of gift-tax rates; the selective approach was continued in the field of indirect taxation, with further substantial increases being levied on luxury articles, and numerous new taxes being imposed, as was customary, at the manufacturing level; a new departure was the introduction of a stamp tax on various forms of jewellery and cut-glass ware, at the retail level.

The total tax yield in the 1943 fiscal year amounted to \$2,187 million, of which \$70 million was refundable after the war.⁴⁵ The government emphasized that it did not regard the new compulsory savings feature as a substitute for voluntary saving. The success of the programme of war finance required substantial increases in current saving, for despite record tax revenues, their deficiency in relation to cash requirements was almost twice as great as in the

⁴⁴J. L. Ilsley, *Budget Speech*, June 23, 1942, p. 8.

⁴⁵For the detailed tax measures, see J. L. Ilsley, *Budget Speech*, June 23, 1942, pp. 29-31.

preceding year.⁴⁶ While reduction of cash balances and the usual investment of monies from government accounts met some part of the additional need for cash, it was clear that dependence upon the public and/or the banking system would be much greater than ever before. Although the Third Victory Loan, the largest war-time issue floated to this time, provided the government with almost \$1 billion in cash, this represented less than half of borrowing requirements for the fiscal year, and heavy reliance upon the banking system was therefore unavoidable. Direct borrowing from the chartered banks was confined to a new type of instrument, the deposit certificate, issued periodically with a twenty-six weeks maturity, and bearing interest at three-quarters of 1 per cent. This instrument provided the government with funds in the intervals between the periodic public loan campaigns, and was the major source of bank borrowing during the 1943 fiscal year. Coupled with cash sales to the Bank of Canada, the government's borrowing from the banking system exceeded \$1 billion (Table I).

At the end of the fiscal year, the direct unmatured funded debt was more than twice as great as at the beginning of the war, but the proportion payable in foreign markets had steadily declined. Repatriation of direct debt was actually a short-lived means of providing the sterling area with appreciable quantities of Canadian dollars, and for obvious reasons, the receipt of British gold was likewise unimportant. The accumulation of sterling balances was the major technique, subsequently supplemented by outright gifts. During the 1943 fiscal year, an interest-free loan of \$700 million represented the means by which the Foreign Exchange Control Board disposed of the bulk of the sterling balances which it had accumulated up to that time.⁴⁷ Reviewing the year's fiscal operations, the minister of finance pointed to the undesirability of such heavy bank borrowing, and to the corresponding need for greater loans from current savings in succeeding periods.⁴⁸ In connexion with the interest-free loan to Britain, the Bank of Canada sold to the Foreign Exchange Control Board exchange which it had purchased earlier on a temporary basis. To counteract the consequent reduction in chartered bank reserves, and also to provide for the increase in chartered bank liabilities arising from their purchases of deposit certificates after the beginning of July, the Bank engaged in open-market buying, and its net security holdings increased substantially during the fiscal year (Table II). The increase in the chartered banks' investments was likewise largely attributable to their purchases of these deposit certificates. By contrast, the volume of their Canadian loans showed a marked decline for the first time since the beginning of the war (Table III). The supply of money increased by approximately 14 per cent, while the index of the physical volume of production rose by 22 per cent in calendar year 1942. In contrast to the preceding year, the wholesale price index rose relatively little in 1942, from 129.5 to 134.2, while that of the cost-of-living rose from

⁴⁶Bank of Canada, *Statistical Summary*, June-July, 1946, pp. 51-2.

⁴⁷See Foreign Exchange Control Board, *Report to the Minister of Finance*, p. 34.

⁴⁸See J. L. Ilsley, *Budget Speech*, Mar. 2, 1943, p. 6, and Bank of Canada, *Annual Report*, Feb. 9, 1943, p. 10.

114.9 to 117.9.⁴⁹ It was therefore apparent that despite the much greater dependence upon bank borrowing during fiscal year 1943, the anti-inflation programme had been somewhat more successful than in the preceding period. There is little doubt that much of the explanation is to be found in the increased support derived from the new price control policy which had been introduced in December, 1941.

The government's cash requirements reached a peak of \$5,633 million in fiscal year 1944. Noting that this figure was 19 per cent greater than that of the preceding period, and recalling the recent substantial dependence upon bank borrowing, the minister of finance observed that inflationary forces could be held in check "only by the rigour of our existing taxation, by the willingness of Canadians to save on an unprecedented scale, and by our price control and wage control."⁵⁰ By this time, government expenditures involved a diversion of one-half of the national income, but despite this high proportion taxation provided 48 per cent of the year's funds, borrowing 51 per cent, and a decline in cash balances therefore took place. The government believed that the tax levels attained in the previous budget could not be increased appreciably without causing "undue" hardship in particular cases, and that any increase in existing income tax rates would meet with serious difficulties, both of equity and of administration.⁵¹ Proposals were therefore introduced to improve and simplify various taxes, but increases were relatively small. The personal income tax was placed on a basis of current collection, an accomplishment which was facilitated by the cancellation of the entire tax liability of individuals with respect to 1942 income. Some additional taxes were placed on alcoholic beverages, tobaccos and amusements, and the postal rate on letters was increased by one cent per ounce. The tariff changes were minor, and again were designed principally to equalize the increase in excise taxes.⁵² It was emphasized that not only must voluntary savings and loans to the government be increased, but that the people must hold the securities which they purchased, since a mere temporary shift of assets would not accomplish the desired objectives. The year's tax modifications yielded \$445 million in additional revenue, about one-half of additional cash requirements. The unmatured funded debt rose by almost \$3 billion as war-time financial needs reached a peak but, in contrast to the preceding

⁴⁹*Report of the Wartime Prices and Trade Board*, pp. 112-15.

⁵⁰J. L. Ilsley, *Budget Speech*, Mar. 2, 1943, p. 1. Factors contributing to the inflationary pressure, other than monetary expansion, included a state of full employment, a continuing decline in the output of consumers' goods, fewer and higher cost imports, and widespread cost-price selling-price squeezes.

⁵¹*Ibid.*, p. 8.

⁵²*Ibid.*, p. 22. The following comment by the minister of finance is interesting: "The customs tariff has fallen from the high position it has previously held as an instrument of fiscal and economic policy. Under the circumstances of war, the tariff has little effect except as a producer of revenue. The scope and direction of trade are now governed by the considerations of supply, transportation and enemy action and not by the tariff. . . . There will again, however, be a time when the tariff will be an important instrument of policy and when this country will have to decide whether it will play its part with other countries which are prepared to help in freeing the world's trade, in enlarging markets, and in promoting the full and effective use of the world's resources."

period, the amount of new funds required from the banking system was small. This was a result of the sale of the Fourth and Fifth Victory Loans to the general public, which together provided cash in excess of \$2½ billion, an amount which far surpassed the proceeds from public borrowing in any preceding year. The only cash obtained directly from the banking system was provided by the chartered banks in a relatively small amount (Table I). The major method adopted in financing the sterling area's deficit of Canadian dollars was the establishment of the Canadian Mutual Aid Board, under whose jurisdiction an appropriation of \$1 billion was made available to the United Nations, in order to supply them with materials needed for the effective prosecution of the war.⁵³ By the end of the fiscal year, more than nine-tenths of the appropriation had been used. The British government reduced slightly the unpaid balance of its \$700 million loan from Canada by providing the Canadian government with United States dollars in the amount of \$40 million Canadian.

For the first time since the establishment of the Bank of Canada, its rediscount rate was changed, in February, 1944, being reduced from 2½ per cent to 1½ per cent. Since rediscount facilities were seldom used by the chartered banks, the reduction was not of immediate consequence, and its main object was to indicate the Bank's intention of continuing after the war its easy-money policy which had brought about the existing levels of interest rates.⁵⁴

Despite the relatively small amount of cash obtained from the banking system through the sale of new issues, the increase in the supply of money was one of the greatest of any war-time fiscal year. This is explained, of course, by the banking system's substantial acquisitions of outstanding securities in the intervals between the periodic public loan campaigns: A rough measure of these re-purchases may be obtained from Table II and Table III, if from the increase in the banks' holdings of government securities their direct purchases at time of issue (Table I) are deducted.⁵⁵ An alternative indication of their volume is furnished by the fact that whereas the banking system's direct purchases represented approximately 13 per cent of the war-time increase in the funded debt, the National War Finance Committee estimated that when consideration was given to securities transactions *after* their original marketing, the banking system held almost 30 per cent of the war-time debt increase. The increase in the supply of money (Table IV) was approximately 18 per cent. But despite the continued monetary expansion which was occurring in conjunction with a growing scarcity of civilian goods and services, the wholesale price index moved only from 134.2 to 141.8, and the cost-of-living index from 117.9 to 118.4 in the 1943 calendar year.⁵⁶

Reviewing the economic developments during this period, the government again stressed the contribution which price- and wage-control, in supplementing fiscal policy, had made to the minimizing of inflation in a period when the

⁵³See The War Appropriation (United Nations Mutual Aid) Act, May 20, 1943.

⁵⁴Bank of Canada, *Annual Report*, Feb. 10, 1944, pp. 5-6.

⁵⁵See also MacGregor, "The Problem of Price Level in Canada," p. 185.

⁵⁶*Report of the Wartime Prices and Trade Board*, pp. 68-70.

financial requirements of the government had reached a maximum.

When introducing his budget for the 1945 fiscal year, the minister of finance noted that the period of the most extensive Allied military action had already begun, a fact which prevented any immediate appreciable reduction in the outlays of the Canadian government. In fact, it was stated that there was a strong possibility that the budgetary deficit for the fiscal year would be greater than for the year just past.⁵⁷ The total cash requirements of \$5.6 billion were only 1 per cent lower than those of the preceding year. Taxes and other revenues provided 49 per cent of the total, borrowing 53 per cent, and a consequent increase in cash balances was realized.⁵⁸ The 1944 gross national product had reached a war-time peak of \$11.8 billion, and since this represented a 6 per cent increase over 1943, cash requirements were a slightly smaller proportion of national income than in the preceding year, approximating 48 per cent.⁵⁹

The year's fiscal measures were guided by four basic considerations. These included the magnitude of cash requirements, the urgent need for encouraging a supreme productive effort in view of the scope of military operations which were approaching their climax, the desire to remove certain anomalies and cases of particular hardship arising from the high levels of taxation, and finally the wish to clarify post-war fiscal policy in order that business might have some measure of certainty in planning reconversion.

The tax proposals were similar to those of the preceding year in that no major changes were introduced. The emphasis continued to fall upon improved administration and the removal of inequities. To relieve increasingly widespread discontent arising from the high rates of personal income tax deduction at the source, the refundable portion of the tax was dropped. This, of course, intensified the need for higher levels of voluntary saving by the general public. The bases for claiming deductions from gross income were also extended. In relation to the forthcoming period of reconversion, the problems of which were accorded budgetary recognition for the first time, the most significant changes were those in the business income tax and the excess profits tax. For example, beginning with the taxation year 1944, business enterprise, including farming, was permitted a three year carry-over of losses in place of the previous one year provision (two years for farmers). Double depreciation rates were permitted on certain assets, and provisions governing deductible expenditures were made more liberal. For corporations established after June 26, 1944, the total tax liability in their first fiscal year of operations was limited to a flat rate of 40 per cent on profits, and thereafter was set in

⁵⁷The term "budgetary deficit" is used to indicate the increase in net debt, hence does not represent the amount of the government's borrowing needs. This latter amount is equal to total cash requirements less total revenues, and is known as the "cash deficiency." In the 1944 fiscal year, the cash deficiency was 10 per cent higher than the budgetary deficit, but in three of the earlier war years, when repatriation and the accumulation of sterling balances was proceeding on a large scale, the cash deficiency was more than double the budgetary deficit. For the war period to the end of fiscal year 1944, the cash deficiency was 50 per cent greater than the budgetary deficit.

⁵⁸Bank of Canada, *Statistical Summary*, June-July, 1946, pp. 51-2.

⁵⁹Bank of Canada, *Statistical Summary*, 1946 Supplement, p. 64.

accordance with whatever standard profit was awarded to the owners of the business. Certain formulae were provided whereby businesses might revise their "standard" profits upward. To assist agriculture, customs duties and the war exchange tax on agricultural implements were removed. The schedule of the War Exchange Conservation Act was repealed, since the government's foreign exchange position was no longer critical, and perhaps because increased imports from the United States were unlikely in any case.

The funded debt operations in 1945 involved little borrowing from the banking system. The Sixth and Seventh Victory Loans provided the government with almost \$3 billion in cash, so that once again the direct cash borrowing from the banking system was limited to a relatively small amount provided by the chartered banks (Table I). The financing of the sterling area's purchases in Canada was facilitated by an additional appropriation of \$800 million, under the terms of the War Appropriation (United Nations Mutual Aid) Act of June 23, 1944. At the beginning of the fiscal year, an unspent balance of \$100 million had been available from the preceding year's loan, and total expenditures under Mutual Aid in the 1945 fiscal year amounted to \$803 million.⁶⁰ The United Kingdom was again able to reduce her indebtedness to Canada with respect to her 1943 loan by transferring United States dollars in the amount of \$55 million Canadian.

The increase in the supply of money, although appreciably smaller than in the preceding fiscal year (Table IV), nevertheless exceeded 13 per cent. That the economy had reached the limits of its productive capacity was indicated by the fact that the index of the physical volume of business rose only one point from 236 to 237 in the 1944 calendar year. The cost-of-living index showed a fractional decline, and that of wholesale prices was unchanged.⁶¹ The government offered a very optimistic interpretation of its success in combatting inflation as it reviewed the events of 1944, and not without some reason, although there was little doubt that increased difficulties would present themselves in the succeeding period, when some of the unusually favourable circumstances which had prevailed in 1944 might not again be present, and when other inflationary pressures would be increasingly severe.⁶²

Although the military operations of World War II ended in August, 1945, the budget for the 1946 fiscal year was essentially a war measure, and for that reason, its effects upon monetary expansion are included in this survey of Canada's war-time fiscal policy. At the same time, it was a peace-time measure, inasmuch as "... its effects on employment and income must be accepted as of major importance."⁶³ Its measures were therefore designed not only to meet the year's financial requirements, but also to facilitate an orderly process of reconversion, and the government therefore believed it appropriate to ease the burden of war-time taxation.⁶⁴ The basic feature of the budget was therefore the first appreciable decline from the highest levels

⁶⁰Bank of Canada, *Statistical Summary*, June-July, 1946, pp. 51-2.

⁶¹*Report of the Wartime Prices and Trade Board* (Ottawa, 1945), pp. 68-70.

⁶²*Ibid.*, pp. 3-4.

⁶³J. L. Ilsley, *Budget Speech*, Oct. 12, 1945, pp. 3-4.

⁶⁴See *ibid.*, pp. 6, 13.

of war-time taxation, leaving a somewhat larger deficit to be financed by borrowing. The government's cash requirements fell by only 7 per cent, and of a total of \$5,254 million, taxation provided 55 per cent and borrowing 55 per cent, with a corresponding increase in cash balances.⁶⁵ The government was now spending 46 per cent of national income which had declined slightly to \$11.4 billion in 1945. The principal tax modifications included the removal of the 10 per cent war exchange tax on all imports from non-Empire countries; the removal of the sales tax from machinery and apparatus which was to be used "directly" in the process of manufacture or production; the abolition of the refundable portion of the excess profits tax, and reduction of the tax rate to 60 per cent; an increase in the minimum "standard" profit of all firms from \$5,000 to \$15,000; a flat-rate reduction of 16 per cent in the personal income tax; the modification of the taxation of annuities and pensions, and the reduction of duties in the event of "quick" succession.

Total revenues and total borrowing were approximately equal during the 1946 fiscal year. The Eighth and Ninth Victory Loans provided more than \$3½ billion from the general public (Table I), an amount which considerably exceeded that which was obtained in any other fiscal year. Not only was no direct borrowing effected from the banking system but a substantial decrease occurred in the chartered banks' holdings of deposit certificates (Table III).⁶⁶ However, the banks indirectly absorbed government securities on a substantial scale (Tables II, III), and the increase in the supply of money was the greatest that occurred during the war (Table IV), amounting to 14 per cent. For the first time since the beginning of the war, the index of the physical volume of business declined, falling from 237 to 213 during 1945. The wholesale price index rose from 141.8 to 143.5, and that of the cost-of-living from 117.6 to 119.1 in the same interval. This latter increase was the greatest indicated by official sources since 1942.⁶⁷ The minister of finance warned against the continuing inflationary pressures, the presence of which was indicated by these price trends, and pointed to the undiminished need for sound fiscal policy supported by continued direct controls, if these pressures were not to inflict serious damage upon the post-war economy in the very critical period of reconversion.

We may now summarize briefly the borrowing operations of the Canadian government between September, 1939, and March 31, 1946. The total amount of new cash (total borrowings less conversions and renewals) raised within Canada amounted to \$14,832 million. Of this total, the general public, i.e., sources other than the chartered banks and the Bank of Canada, provided \$12,541 million. Excluding the purchase of treasury bills, the Bank of Canada

⁶⁵Bank of Canada, *Statistical Summary*, June-July, 1946, pp. 51-2.

⁶⁶The rate on these obligations was reduced to five-eighths of 1 per cent on March 5, 1946. At the same time, the government reached an agreement with the chartered banks which limited their holdings of government securities, other than very short-term securities, to 90 per cent of Canadian savings deposits. See the *Canadian Banker*, 1946, p. 32.

⁶⁷The difficulties associated with maintaining a realistic cost-of-living index in war-time were generally recognized. Few persons accepted the official figures as indicating the realities of the situation.

provided \$444 million, and the chartered banks \$1,551 million. The net increase in treasury bills outstanding was \$296 million.⁶⁸ In terms of percentages, the general public provided 85 per cent of all new funds, the Bank of Canada 3 per cent and the chartered banks 10 per cent. The sale of treasury bills by public tender, of whose ownership no detailed figures are available, provided the remaining 2 per cent. Such was the distribution of original purchases. On only two occasions was borrowing undertaken in the New York market, and in each case the proceeds were used there to assist in retiring larger maturing issues. The total of these borrowings was small, and there were no funded borrowing operations in the London market.

It should be recognized that while the general public provided 85 per cent of all new funds at the time of original sales of securities, the chartered banks were indirectly responsible for a considerable part of those subscriptions. Bank credit was particularly important in the temporary financing of bond purchases by various investors, both in connexion with official installment plans and with deferred deliveries and other arrangements. Of the total known credit provided for the public's purchases of bonds, the amount supplied by the commercial banks represented perhaps 95 per cent.⁶⁹ The known credit averaged approximately one-quarter of the purchase price of the various war-time issues, but in all cases, was liquidated before a succeeding issue was floated.

In terms of the functions of war finance, it is instructive to compare the accomplishments of the Canadian government in two world wars.⁷⁰ With regard to raising the necessary funds, the sources employed in World War II represent a marked contrast to those of the earlier period. On that occasion, almost the entire costs of the war were met by borrowing, since taxation and other revenues failed to provide sufficient cash to take care of the government's non-war outlays, including capital expenditures. Furthermore, borrowing from foreign sources was possible in the early stages of the war, although changing circumstances operated to necessitate increasing dependence upon the domestic market until it finally became almost the sole source of funds, and by far the more important source over the war period as a whole. The inadequacy of tax revenues can be explained partly by the undeveloped state of the Canadian tax system in 1914, in which customs duties, the major source of revenue, were supplemented by excise revenues. Under such circumstances, any rapid expansion of revenues would have been impossible, but it is important to note that the government's philosophy was such that tax increases were considered neither economically nor politically desirable, even if they had been possible. The entire programme of war finance was developed from

⁶⁸*Public Accounts, 1945*, p. lii. See also J. L. Ilsley, *Appendix to the Budget, 1946-47*, p. 41.

⁶⁹National War Finance Committee, *Dominion Government Public Borrowing*, p. 16.

⁷⁰For a concise account of the early experience, see J. J. Deutsch, "War Finance and the Canadian Economy, 1914-1920" (*Canadian Journal of Economics and Political Science*, vol. VI, 1940). The contributions of the banking system to war finance are best described by C. A. Curtis, "The Canadian Banks of War Finance" (in *Contributions to Canadian Economics*, Toronto, 1931), III. See also F. A. Knox, "Canadian War Finance and the Balance of Payments, 1914-18" (*Canadian Journal of Economics and Political Science*, vol. VI, 1940).

essentially faulty premises, a criticism which can scarcely be maintained with reference to the approach in World War II. Finding itself forced back upon a hitherto untried domestic market, the government's World War I borrowing involved the extensive use of bank credit, a circumstance directly related to another function of war finance, that of assisting in the efficient allocation of resources to war production. The value of national income produced about doubled between 1914 and 1919, but the increase in real output during that period was almost certainly less than 10 per cent.⁷¹ The general order of these figures suggests the degree to which inflationary developments contributed to the rise in money incomes, and to which the money costs of carrying on the war were increased. It has been shown, however, that it was this inflation which made possible the large-scale domestic public borrowing which was effected in the later stages of the war, prompting the comment that the financial programme was "more expedient than equitable."⁷² Touching upon the third function of war finance, it is clear that considerations of equity were notably absent in the earlier period. This was tolerable, if not defensible, in a situation where the government absorbed not more than 10 per cent of the national income in financing its war expenditures. In World War II, where these expenditures rose to one-half of the national income, the adoption of policies pursued in the earlier period would have been intolerable.

As a consequence of the World War I experience, the Canadian government was determined to avoid such heavy reliance upon borrowing as a means of financing the recent conflict. To this end, it took active steps to condition the public to the possibility of a long and costly war. In general, it may be said that the whole economic approach to the problem of financing World War II was more sound than in the earlier period, and that the monetary-fiscal techniques available for implementing the programme were much better developed.

It has already been emphasized that in determining the particular policies of war finance that are to be adopted, the government necessarily becomes involved not only in considerations of economics but also of politics. While the minister of finance may have little doubt as to the technically desirable course of action under given circumstances, his actions will be modified in varying degrees by considerations of political expediency and public acceptability. One important function of war-time propaganda thus becomes that of educating the public to accept and support, in as large measure as possible, the economic programme which past experience has indicated as being essential to the most effective prosecution of the war. The success of the Canadian experience was in no small measure a result of the persistent campaign which presented to the great majority of the citizens, in clear and simple terms, the need for the stringent measures which were enacted, and which were generally supported, as the war effort developed.

With the early and continued insistence of the government upon a basic pay-as-you-go policy which was to be pursued to the limits of its practica-

⁷¹Deutsch, "War Finance and the Canadian Economy," especially pp. 530, 532.

⁷²*Ibid.*

bility, there will be general agreement. In the early months of the war, this policy was held in abeyance while a deliberate programme of monetary expansion was undertaken, in order to absorb the slack which was present in the Canadian economy at the outbreak of the war. While this programme was also undoubtedly justified, there is evidence that it was not without its inflationary effects, despite government predictions to the contrary. Relatively rapid rises in price levels occurred during the first two years of the war, suggesting that the expansionist policy had been pursued somewhat beyond desirable limits. While full employment was the objective, such an area is impossible to define, and the inflationary effects of bottlenecks which developed in various segments of the economy were undoubtedly underestimated. The cessation of deliberate monetary expansion and the adoption of an overall price ceiling late in 1941 coincided with a pronounced check to the price increases, a check which cannot be explained, however, completely in terms of these two factors.⁷³

In its efforts to derive the greatest possible proportion of its cash requirements from taxation, the government effected a substantial expansion and improvement of the federal tax system. The magnitude of the increase in tax revenues may be explained in terms of the increase in the national income, the increase in the rates of existing taxes, and the addition of new taxes to the system. The war-time emphasis upon direct taxation served to lessen the regressiveness of the system as a whole. An additional effect of the programme of war finance was to redistribute the national income in favour of the wage-earning and agricultural classes.⁷⁴

The expansion of tax revenues was consistently based upon the ability-to-pay principle, a matter of basic importance in a situation where such a large part of the national income was required in financing the war effort. The difficulties of administering the tax programme on such a basis were increased by the fact that Canada has a high proportion of small incomes, and that in her primarily agricultural economy a substantial amount of income is received in kind, rendering the calculation of the net income of the farming population next to impossible.⁷⁵ The additional problem presented by the particular allocation of taxing powers between the federal and the provincial governments was resolved for the duration of the war when the provinces agreed to vacate the fields of personal and corporate income taxation, in return for fixed pay-

⁷³See Benjamin H. Higgins, *Canada's Financial System in War* (New York, 1944). The introduction of consumer rationing, the increased use of subsidies and the introduction of higher income taxes were additional factors to be considered.

⁷⁴See Bank of Canada, *Statistical Summary, 1946 Supplement*, pp. 102-3, 107. The index of the farm price of agricultural products rose from 91.8 in 1939 to 176.5 in 1945 (1935-9 = 100). Using the same base, farm operating costs rose from 99.5 to 123.5 in the same interval. The index of average wage rates in ten major groups of industries rose from 105.3 to 147.8, and the cost-of-living index from 101.5 to 119.5. See also J. L. Ilsley, *Budget Speech*, Mar. 2, 1943, pp. 5-6.

⁷⁵The relative unimportance of agricultural income as a source of tax revenue is indicated by the fact that in the taxation year 1941, for example, the total tax levied amounted to only \$1.6 million, on an assessed income of \$18.2 million. On this point, see Department of National Revenue, *Taxation Statistics* (Ottawa, 1946), p. 115.

ments from the federal government. However, the Canadian tax system as a whole, having been developed in large measure through fiscal and political expediency, left much to be desired as a weapon of war-time fiscal policy. In expanding the system to provide for enormously expanded war-time financial requirements, the government wisely concentrated its efforts upon the greater use of direct taxation, since the system was already seriously regressive. The major sources of war-time tax revenues were the yields from personal income, corporation income and excess profits taxes, and succession duties.

In attempting to finance as large a part of its war expenditures as possible on a pay-as-you-go basis, the government can scarcely be charged with failing to utilize the foregoing sources of revenue to the limits of their practicability. For the entire war period, the personal income tax and the corporation income tax including excess profits tax yielded approximately equal revenue. In both instances, the highest rates of taxation were introduced in the 1942 budget, and were continued substantially unchanged through 1945. The government's self-determined criteria of the desirable limits of taxation were expressed in terms of the need to maintain initiative, to prevent the wasteful use of productive resources and to adhere to the ability-to-pay principle. However difficult it may be to translate the last criterion into practice, there is little doubt that as a result of the emphasis upon direct taxes, regressiveness was substantially lessened, as already noted, during the war years. With reference to the other criteria of tax policy, it seems clear that the government frequently exceeded its announced intentions. This is perhaps not surprising in a situation where the minister of finance continually found that "fiscal necessity and the rude facts of war press us hard."⁷⁶ In particular, considerable discouragement of individual initiative was encountered because of the high rates of personal income taxation, although this discouragement arose in some degree because of a misunderstanding, particularly on the part of labour, of how graduated tax deductions at the source actually affected the ultimate tax payable. However, it was only in relatively few instances that the very heavy combined levies on business enterprise extended to an actual impairment of capital, and the severity of the war-time measures for the limitation of business profits was not such as to precipitate the serious post-war transitional difficulties which had frequently been predicted by industry.⁷⁷ It is not to be denied, however, that the role of taxation in the overall war effort was adequately understood, and, on the whole, effectively implemented. In both respects, Canadian tax policy in World War II was very much superior to that in World War I, and in obtaining from taxation an amount of cash which approached one-half of its total war-time cash deficiency, the accomplishment of the government was one which compares very favourably with the records established by any of the other major belligerents.

While all taxation may not be categorically designated as a non-inflationary means of war finance, nor all borrowing designated as inflationary, these

⁷⁶J. L. Ilsley, *Budget Speech*, June 23, 1942, p. 9.

⁷⁷For an analysis of the war-time profits statistics of selected groups of business enterprise in Canada, see the Bank of Canada, *Statistical Summary, 1946 Supplement*, pp. 52-62.

probabilities are supported by abundant empirical evidence, and are almost certainly as valid as any other generalization. Accordingly, in the borrowing of that part of its war requirements which could not be met from tax revenues, the Canadian government, with World War I experience as a notable object-lesson, recognized the importance of minimizing the inflationary potentialities of its financial programme. In this it was effectively supported by the Bank of Canada, a comparatively recent addition to the Canadian banking structure. The three sources of borrowing available to the government were the general public, including financial institutions other than banks, the commercial banking system, and the Bank of Canada. The relative importance of these three sources of war-time funds has already been indicated. The bulk of borrowing from the central bank was effected in the early stages of the war when the government's monetary policy was one of deliberate expansion. Thereafter, direct borrowing was confined almost exclusively to the general public and to the commercial banks. The campaign for borrowing from the general public was very ably conducted by the National War Finance Committee, established in January, 1942, and disbanded in December, 1945. To the extent that such public borrowing fell short of meeting its financial needs, the government turned to the commercial banks as a residual source of funds.

In comparing the extent to which the government was able to restrict inflation in the two wars, it is clear that the relative success attained during World War II cannot be explained in terms of differences in the degree of monetary expansion which took place during the two conflicts. From the end of fiscal year 1939 to that of 1946, the total quantity of money increased, in round figures, from \$3 billion to \$7 billion, or by approximately 133 per cent (Table IV). In World War I, from the end of 1913 to that of 1918, the increase was from \$1.2 billion to \$2.1 billion, amounting to only 75 per cent.⁷⁸ But as already noted, the war-time expansion of real income was very much greater during World War II, as was the proportion which was diverted to war purposes. A much sounder conception and implementation of fiscal policy during World War II confined monetary expansion within limits which, with less vigorous leadership and less public support, might have been substantially exceeded. Any attempt to have financed the recent war effort through the approach adopted after 1914 would undoubtedly have led to chaos. While a proportionately greater monetary expansion occurred during World War II, the restriction of inflation was facilitated by the tremendous increase in Canadian productive capacity and by the government's programme of direct economic controls which effectively supplemented its fiscal policies.

To the degree that the government was successful in controlling inflation, it also contributed to its third objective of war finance, that of the equitable allocation of the financial costs of the war. The effects of inflation were recognized as constituting a thinly disguised process of taxation of the most arbitrary, unjust, and undesirable type. By minimizing this enforced reduction of purchasing power and by concentrating upon direct (income) taxation, the government probably distributed the war-time financial burden

⁷⁸Deutsch, "War Finance and the Canadian Economy," p. 540.

in a manner as satisfactory as the complexities of the Canadian tax system and as the very heavy financial requirements would permit.

In referring to one of the basic objectives of war finance, that of assisting in combatting inflation, the minister of finance indicated that the government's reliance upon the commercial banking system, and the consequent monetary expansion which took place during the war years, was considerably greater than he had hoped would have been necessary. An accompanying feature of this monetizing of the public debt was the marked alteration in the relative importance of the earning assets of the commercial banks, with government securities supplanting loans as the asset of major importance. As of the end of 1945, this change in the Canadian banking situation had brought about the following specific results:

Security holdings now represent more than 55% of the total assets of the banking system while loans in Canada are less than 20% of the total. Just before the war, securities accounted for slightly more than 40% of bank assets while loans were in the neighbourhood of 30%. If we go back to the late 'twenties, we find that loans comprise a much larger proportion of bank assets than did securities and if we look back before the First World War, we see that over 60% of bank assets were in the form of loans and that securities were comparatively unimportant. The truth is that the war accelerated a trend which has already been in evidence for a generation not only in Canada but in the United States and Great Britain. . . . This radical change reflects fundamental alterations in the business structure, in the role of government in economic life, and in international relationships and conditions. It is unlikely that loans will regain their former preponderance over securities in banking assets.⁷⁹

In emphasizing the slight prospects for reduction of the bank's holdings of the public debt for some time to come, it might also have been noted that this trend represents a substantial change in the economic functions performed by our commercial banks, and this has raised the question in some quarters as to the most desirable means of remunerating the banks for their modified services. The high proportion of earning assets held by the banks in the form of public debt ties the future of the banking system very closely to the market for federal government securities, a market in which the Bank of Canada will necessarily occupy a position of great importance.

The intention of the Bank to maintain a pattern of low interest rates in the post-war period has already been noted. That such an easy-money policy can be maintained without serious danger of further inflation is not a view that is universally shared. The low interest-rate policy in Canada was a legacy from the depression following 1929, many of the effects of which were still present a decade later when war was declared. The continuation of the policy throughout the war years facilitated the government's programme of war finance, restricting the service costs of the mounting national debt to as low a level as possible. Among the difficulties of maintaining the low level of rates is the fact that the central bank must at all times be prepared to support the market through its open-market purchases, a process which provides the commercial banks with additional reserves, and facilitates credit expansion. The consequent ability of the Bank of Canada to adhere to its low interest-rate policy for an indefinite period, without at the same time risking seriously

⁷⁹H. L. Enman, "Annual Report of the General Manager of the Bank of Nova Scotia" (*Canadian Finance*, Dec. 19, 1945, p. 16).

inflationary consequences, seems highly questionable.⁸⁰ Here the Bank's recent modification of its support of the federal bond market is instructive.

Despite the continuous reduction in the average rate of interest payable on the national debt during the war years, the total service charge is now as great as the amount of the government's pre-war budget. To lessen the problems associated with this fixed transfer expenditure, the government encouraged the widest possible distribution of the ownership of the debt, a policy in which it was fairly successful. However, to the extent that the taxes necessary for meeting these expenditures contribute to general levels which discourage initiative, reduce production, and result in a lower real income, some part of the real cost of the war will have been passed to succeeding generations.⁸¹

In the history of the Canadian economy, where the national income has been notoriously variable, the problem posed by the existence of substantial fixed charges has been one of recurring difficulty. The exigencies of the recent programme of war finance, despite the very creditable manner in which that programme was developed, have accentuated this general problem. For the maintenance of a high level of employment in Canada, and for her continued economic expansion, it is extremely important, and in fact indispensable, that a substantial measure of freedom in post-war international trading be developed, in order to permit the expansion of foreign markets on which the Canadian economy is peculiarly dependent. A substantial volume of international trade, developed on a normal basis, is the *sine qua non* for maintaining a relatively high Canadian national income. If this can be accomplished, the burden of fixed charges will be effectively eased. But the problem may also be attacked, and should be attacked, from the standpoint of reducing the amount of these fixed charges. This approach is particularly attractive at the present time. For the immediate future, it seems fairly certain that inflation is the general condition which must be combatted in Canada, as in the United States. In view of this situation, an obviously desirable step is that of balancing the federal budget, and of accumulating a surplus to be used to initiate a programme of debt retirement. The surplus should be used to retire bank-held debt, and no further bank borrowing should be undertaken. It is to be hoped that the continued sale of the post-war Canada Savings

⁸⁰For a discussion of the considerations involved in the desirable levels of post-war interest rates, see H. C. Wallich, "Changing Significance of the Interest Rate" (*American Economic Review*, vol. XXXVI, Dec., 1946, pp. 761-87).

⁸¹The question of how great was the real cost of the war (the amount of real income actually sacrificed) is of considerable interest, in view of the amount of unemployment prevailing in Canada in 1939. Despite the substantial diversion of resources to war purposes, the level of civilian consumption may not have declined by a very considerable amount. On the basis of figures supplied by the Dominion Bureau of Statistics, an interesting investigation might be pursued along these lines. It is a matter for speculation as to how the actual output of civilian goods during the war (under conditions approximating full employment) would compare with the output that would have been produced had the war not occurred, in which case unemployment would almost certainly have continued on some appreciable scale. While such an investigation would perhaps not justify the conclusion that the war was economically "costless," it may well be that the real cost might be found to be considerably less than commonly supposed.

Bonds, through absorbing the savings of individual citizens, will permit a continued demonetizing of the debt, with consequent reduction in the money supply. Such a reduction will at best be a slow and difficult process, and with continued insistence by the government upon maintenance of the present levels of interest rates, the process may well be impossible. Under presently prevailing conditions, debt reduction is not only economically desirable but politically practicable. Coupled with the present uncertainty as to the financial implications of Canada's international commitments, the strongest argument may be advanced against further *ad hoc* tax reductions. The effective easing of the burden of the Canadian taxpayer will best be accomplished through arriving at a more satisfactory basis for the allocation of taxing powers between the federal and the provincial governments, thereby permitting improvements in the tax system.

In the period since Confederation, the years in which the national debt has been reduced have been very few, and have been concentrated almost exclusively in the nineteen-twenties. The secular rise has been punctuated by sharp increases in periods of war and depression. The immediate future presents the urgent opportunity for the initiation of a fiscal policy which, while lessening the fixed charges upon the economy, will contribute at the same time to the present and future economic stability of Canada.

R. CRAIG McIVOR

McMaster University.

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